

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:LM:FSH:BRK:TL-N-5156-00  
TKerrigan

date:

to: Section Chief, Quality Measurement Staff  
Attention: Manager Group 1045

from: Associate Area Counsel  
CC:LM:FSH:BRK

subject:

E.I.N. [REDACTED]  
Taxable year [REDACTED]  
U.I.L. No. 0263A.03-03

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This memorandum is in response to your request for advice, dated September 1, 2000, concerning the application of the interest capitalization requirements contained in I.R.C. § 263A(f) to the facts set forth below.

**FACTS**

The relevant facts, as we understand them, are as follows: The taxpayer is a manufacturer of [REDACTED]. The taxpayer's operations consist of production machinery located in [REDACTED] buildings that are owned by the taxpayer. The taxpayer financed its purchase of the production machinery through loans and incurred interest expenses from the equipment loans in the amount of \$[REDACTED] for the tax year at issue. The taxpayer also incurred an additional \$[REDACTED] of mortgage interest expenses relating to the acquisition of the [REDACTED] buildings. The taxpayer claimed an interest expense deduction for the amounts paid during the tax year at issue. The revenue

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agent contends that these interest costs are subject to capitalization under the I.R.C. § 263A uniform capitalization rules.

### ISSUE

Whether the taxpayer, based on the facts set forth above, is required to capitalize interest costs under the interest capitalization provisions of I.R.C. § 263A(f).

### LEGAL ANALYSIS

I.R.C. § 263A, which was enacted in the Tax Reform Act of 1986 (Pub. L. 99-514), provides uniform capitalization rules that requires taxpayers to capitalize all direct and certain indirect costs incurred after December 31, 1986, that are allocable to real or tangible property produced by the taxpayer. I.R.C. § 263A(g)(1) specifies that for purposes of I.R.C. § 263A the term "produce" includes construct, build, install, manufacture, develop or improve.

I.R.C. § 263A(f)(1) requires that interest incurred in connection with the production of "designated property" must be capitalized as a cost of the property produced. I.R.C. § 263A(f)(3) further provides that the interest capitalization rules also apply to interest on debt allocable to property (i.e. equipment and facilities) that is used to produce "designated property". See also S. Rep. No. 99-313, 99th Cong. 2d Sess. 144, n.44 (1986). "Designated property" is property that has (1) a long useful life (consisting of all real property and all personal property with a class life of 20 years or more under I.R.C. § 168 that is produced for sale or for use in the taxpayer's trade or business); (2) an estimated production period exceeding two years; or (3) an estimated production period exceeding one year and a cost (excluding interest) exceeding \$1,000,000. See I.R.C. § 263A(f)(1)(B); Treas. Reg. § 1.263A-1(e)(3)(ii)(V). In the present case, the taxpayer's manufactured inventory does not have the requisite production period. Accordingly, the taxpayer is not required to treat any interest as an inventory cost.

In the advice request, the revenue agent suggests that the production machinery rather than the inventory could be considered "designated property" for purposes of I.R.C. § 263A(f). I.R.C. § 263A also requires capitalization of costs incurred in constructing tangible property. The term "self-constructed asset" refers to an asset constructed by a taxpayer for use in its trade or business (for example a manufacturing plant constructed by a taxpayer for its own use). Treas. Reg. § 1.263A-1(d)(1). If the constructed asset has a

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useful life extending substantially beyond the end of the year in which construction is completed, costs of construction are not recovered currently, but are recovered either through depreciation, amortization, or upon sale or other disposition of the property constructed. I.R.C. § 263; Treas. Reg. § 1.263(a)-2(a). In the present case, the production machinery was purchased by the taxpayer. None of the interest incurred by the taxpayer represents construction period interest. Therefore, I.R.C. § 263A(f) would not be applicable in this case because the interest expense was not incurred in connection with the production of the machinery.

#### CONCLUSION

Based on the above, the taxpayer is not subject to the interest capitalization provisions because the taxpayer's inventory is not "designated property" under I.R.C. § 263A(f)(1).

This opinion is based upon the facts set forth herein. It might change if the facts are determined to be incorrect. If the facts are determined to be incorrect, this opinion should not be relied upon. You should be aware that, under routine procedures, which have been established for opinions of this type, we have referred this memorandum to the Office of Chief Counsel for review. That review might result in modifications to the conclusions herein. We will inform you of the result of the review as soon as we hear from that office. In the meantime, the conclusions reached in this opinion should be considered to be only preliminary.

If you have any questions or require further assistance, please contact Thomas Kerrigan at (516) 688-1742.

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By: \_\_\_\_\_

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